

Internal Revenue Service
memorandum

CC:TL-N-3004-88
Br4:JRDomike

date: MAR 3 1988

to: District Counsel, Cleveland CC:CLE:TL

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]
[REDACTED]

This responds to your memorandum dated January 14, 1988 (CASzczepanik) requesting technical advice on the position to take in this declaratory judgment case.

ISSUE

Whether the [REDACTED]'s exemption from income tax pursuant to I.R.C. § 501(c)(3) must be revoked because the amounts distributed from the trust (a private foundation) for educational expenses are taxable under section 4945 and inure to the benefit of private individuals.

FACTS

The facts are included in your memorandum, the National Office Technical Advice Memorandum (TAM), and the Report of Examination - Exempt Organizations. Briefly:

[REDACTED]
(Trust) received exemption on [REDACTED] under the predecessor of I.R.C. § 501(c)(3). The trust was restated on [REDACTED]. Pursuant to Code provisions added by the Tax Reform Act of 1969, Trust is a private foundation under section 509(a) subject to Subchapter A of Chapter 42 (sections 4940-4948) excise taxes.

The board of trustees includes two non-company representatives, the president of [REDACTED] and the president of [REDACTED], and other trustees who are employees of the [REDACTED]. Any appointment of a replacement employee trustee is subject to the approval of the president of [REDACTED].

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Since [REDACTED], the sole activity of the Trust has been the Scholarship Plan for financing vocational education and other forms of higher education of employees and their dependents. Applications for grants are made by the students to any accredited college within a [REDACTED]-mile radius of the plant. The application form is completed at the company personnel office and submitted to the financial aid office of the selected college. Trust disbursement for grants is made to each college in direct proportion to the number of employee (or dependent) applicants at the college. The accompanying cover letter states:

Enclosed is our check to be utilized by [REDACTED] [REDACTED] employees or their dependents in association with the Scholarship Plan. We suggest that this amount be divided equally among the students providing, however, they are eligible according to the Universities' [sic] requirements. However, should disbursement to these individuals in different amounts be more appropriate, we would be supportive of such.

Trust did not seek IRS advance approval of its procedure for awarding grants. The total number of applicants for the [REDACTED] school year was [REDACTED], of which [REDACTED] received grants. Applicants did not receive a grant because they either did not complete the college's grant application, or they withdrew from the college. Only one college excluded applicants for a low grade point average.

The TAM concluded that the grants made by the Trust to the area colleges are taxable payments to individual employees or their dependents for purposes of section 4945(d)(3) because they are "earmarked" grants which are not scholarships under section 4945(g)(1). The TAM further concluded that Trust's exemption under section 501(c)(3) should be revoked since its only activity, the Scholarship Plan, is serving the private interests of the creating employer. The TAM noted that the payments have not been made for educational purposes but tend to serve private interests as a means of extra compensation or a fringe benefit for employees.

The TAM also found that the scholarship program is not used by Trust or the employer to recruit employees or to induce employees to continue their employment, and that the courses of study for which grants are available are not limited to those which would be of particular benefit to the employer or the Trust. The TAM made no finding of collective bargaining.

In the final determination letter dated [REDACTED], the Commissioner revoked the section 501(c)(3) status retroactively to [REDACTED], on the basis that the earnings of Trust inured to the benefit of private individuals.

Trust, in its petition, claims that (a) it irrevocably awards scholarship grants to educational institutions; (b) the power to control the beneficial enjoyment of the scholarship grants has been transferred to the respective educational institutions for an allocation to a certain charitable class (or denial of allocation) without approval or consent of Trust; (c) the educational institutions have and do exercise such control; (d) the initial disbursement by Trust to each educational institution is an attempt to treat all institutions and each scholarship applicant in a nondiscriminatory manner, with the final beneficial amount granted to each scholarship applicant determined by the objective and nondiscriminatory standards set by each institutional scholarship committee; and (e) that the eligible participants in the scholarship program constitute a charitable class which includes employees, their dependents and children of deceased employees, and as such the group is sufficiently broad so that in awarding grants to members of such a group such activity is consistent with fulfillment of the purposes in Rev. Proc. 76-47, 1976-2 C.B. 670, and I.R.C. §§ 501(c)(3) and 170(c)(2)(B).

DISCUSSION

The predicate for the jurisdiction of the Tax Court in this case is the Commissioner's revocation of exempt status under section 501(c)(3) and section 170(c)(2). I.R.C. § 7428(a)(1)(A). Section 501(c)(3)/170(c)(2) requires, inter alia, that the exempt organization be "organized and operated exclusively for ... charitable ... purposes ... [and] no part of the net earnings of which inures to the benefit of any private ... individual ...". The final determination letter in this case states as the reason for the revocation "the fact that the earnings of the trust inured to the benefit of private individuals." For purposes of this discussion, it is noteworthy that the TAM's rationale was that Trust served private interests (i.e., did not operate exclusively for charitable purposes), but did not introduce either inurement or collective bargaining as a rationale.

You have suggested that this case should be controlled by Ohio Teamsters Educational and Safety Training Trust Fund v. Commissioner, 77 T.C. 189 (1981), aff'd, 692 F.2d 432 (6th Cir. 1982). In that case, the Tax Court found that the trust fund was part of a collective bargaining agreement and therefore held that the trust fund was not operated exclusively for a section 501(c)(3) purpose. See also Local Union 712, I.B.E.W. Scholarship Trust Fund v. Commissioner, T.C. Memo. 1983-76. In this case, the TAM did not make a collective bargaining finding. Therefore, neither the facts presently in the record, nor the reason for revocation stated in the determination letter, support reliance on Ohio Teamsters Fund. However, in a revocation case, the administrative record can be supplemented

by discovery and a trial held. T.C. Rule 217(a) and (b)(3). And an additional ground can be raised by respondent if you deem it advisable. T.C. Rule 217(c)(2)(ii).

If not part of a collective bargaining agreement, an employer-related grant program may qualify for exempt status "in appropriate circumstances." See Ohio Teamsters Fund, supra, note 7, 77 T.C. at 199. Before the Tax Reform Act of 1969, courts held that employer-related grant programs qualified for exempt status under section 501(c)(3)/170(c)(2). See Chase v. Commissioner, T.C. Memo: 1960-49 and cases cited therein. The Act introduced the concept of "private foundation" in sections 509(a) and 4940-4948. Thus, while an employer-related grant program can qualify for exempt status under section 501(c)(3), pursuant to section 509(a) the employer-supported organization is a private foundation subject to, inter alia, the strictures of section 4945.

Section 4945 imposes excise tax on "taxable expenditures" which are defined in section 4945(d). As relates to this case, taxable expenditures include two kinds of grants--"a grant to an individual for ... study ... by such individual, unless such grant satisfies the requirements of subsection (g)" (section 4945(d)(3)), and "a grant to an organization unless ... such organization is [a 501(c)(3) organization which is not a private foundation, such as a college] ..." (section 4945(d)(4)(A)).

Petitioner's first argument is that its grants satisfy the requirements of section 4945(d)(4)(A). Its second argument is that they satisfy the requirements of section 4945(g).

Issue 1 in the TAM deals with the requirements of section 4945(d)(4)(A) (without making a clear reference thereto), and finds that Trust exercises such control over the selection of the ultimate individual scholarship recipients that the funding through the colleges does not make the selection independent of Trust for purposes of that section and the regulations. Rev. Rul. 81-217, 1981-2 C.B. 217, provides a useful analysis of this issue.

Issue 2 in the TAM deals with the requirements of section 4945(g) to the extent that it considers section 4945(g)(1) and Rev. Proc. 76-47, 1976-2 C.B. 670, which implements it. It should be noted that in Beneficial Foundation, Inc. v. United States, 8 Cl.Ct. 639, 85-2 USTC ¶ 9601 (Cl.Ct. 1985), the U.S. Claims Court found that the revenue procedure considers relevant factors and enables the Service to properly exercise its discretion pursuant to section 4945(g) [sic]. 85-2 USTC at 89,550.

If the petitioner raises its entitlement under section 4945(g)(3), as did the plaintiff in Beneficial Foundation, you should note that there the Claims Court returned the foundation's application to the Service to make that additional administrative determination under section 4945(g). 85-2 USTC at 89,552-3. The Service has issued Rev. Proc. 80-39, 1980-2 C.B. 772, which provides guidelines for determining whether grants (loans) within the meaning of section 4945(g)(3) are not taxable expenditures. The guidelines therein are almost identical to those in Rev. Proc. 76-47.

For the purposes of adjudicating this case, however, it should be pointed out to the Tax Court that there is no application to be returned to the Service. This case arose out of an examination of the Trust's Form 990-PF (private foundation information return). Presumably excise tax was determined for the years examined, [REDACTED], [REDACTED], and [REDACTED]. In addition, the Service determined that the Trust's exemption must be revoked on account of the expenditure of non-approved moneys in this fashion which resulted in inurement to private individuals.

Section 501(c)(3)/170(c)(2) absolutely requires that "no part of the net earnings of [the exempt organization] inures to the benefit of any private shareholder or individual." The regulations generally define "private shareholder or individual" as "persons having a personal and private interest in the activities of the organization." Treas. Reg. § 1.501(a)-1(c). The regulations under section 501(c)(3) treat inurement of net earnings as evidence of failure to operate exclusively for exempt purposes. Treas. Reg. § 1.501(c)(3)-1(c)(1) and (2). Although the requirement in section 501(c)(3)/170(c)(2) that an organization be operated exclusively for tax-exempt purposes (and not for a private benefit) is statutorily distinct from the prohibition against the inurement of net earnings to the benefit of private individuals, both requirements are often discussed together because much of the evidence is applicable to both. Western Catholic Church v. Commissioner, 73 T.C. 196, 213 (1979), aff'd in an unpub. op., 631 F.2d 736 (7th Cir. 1980); see also 73 T.C. at 211-215. Thus, in Church in Boston v. Commissioner, 71 T.C. 102 (1978), the Tax Court upheld the Service's determination that the petitioner's grant program inured to the benefit of private individuals by finding that the petitioner failed to establish that its grant program constituted an activity in furtherance of an exempt purpose. In its Western Catholic Church opinion, the Tax Court opined that the prohibition against inurement of net earnings "appears redundant", since such a benefit would be inconsistent with operating exclusively for exempt purposes. 73 T.C. at 209, n.27. However, on the same page, the Court explained that the word "exclusively" has been interpreted by the Supreme Court to mean that the presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption. Better

Business Bureau v. United States, 326 U.S. 279, 283 (1945). In contrast, no "substantial" standard applies to inurement; the statute requires that "no part" of the net earnings may inure to the benefit of any individual. Therefore, the inurement provision is not redundant. In Western Catholic Church, the Court found inurement, as well. 73 T.C. at 214-215.

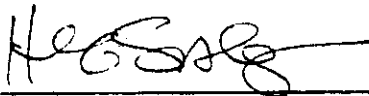
However, the regulations, by defining "private shareholder or individual" as "persons having a personal and private interest in the activities of the organization", have limited inurement to that which benefits a particular class. In this case, where the only declared beneficiaries of Trust are the [REDACTED] employees and their dependents, Trust's Scholarship Plan grants clearly benefit the only persons having a personal and private interest in the activities of the organization.

CONCLUSION

The declaratory judgment litigation in this case may be defended as discussed herein.

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Director

By: _____


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cc: Regional Counsel, Central Region